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No. 80-2211

IN THE
SUPREME COURT OF THE UNITED STATES

Summer Term, 1981

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

v.

WENDEE HENRICKSEN,

Respondent.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

ARGUMENT

I. THERE EXISTS A CASE AND CONTROVERSY REGARDING A CONFLICT BETWEEN §20(a) OF THE 1934 ACT AND FEDERAL COMMON LAW BECAUSE (A) THE COURT OF APPEALS IMPOSED SECONDARY LIABILITY ON SMITH BARNEY UNDER THE COMMON LAW DOCTRINE OF *RESPONDEAT SUPERIOR* WITHOUT DISTINGUISHING GEORGE HENRICKSEN'S VIOLATIONS OF §10(b) OF THE ACT FROM HIS COMMON LAW

TORTS, AND SECONDARY LIABILITY FOR VIOLATION OF A FEDERAL STATUTE MUST BE DETERMINED UNDER FEDERAL LAW; AND (B) FEDERAL LAW MUST HAVE DETERMINED SMITH BARNEY'S SECONDARY LIABILITY FOR GEORGE'S PRE-NOVEMBER, 1976 FRAUDULENT CONVERSION OF WENDEE'S FUNDS BECAUSE WISCONSIN LAW CLEARLY DOES NOT IMPOSE SUCH LIABILITY.

The first question presented by Smith Barney's Petition, as stated in an article which very recently appeared in the *New York Law Journal,*[1] is "whether an employer is liable for the acts of its employees both under the controlling person provisions of securities laws and under the common law principle of *respondeat superior.*" Respondent Wendee Henricksen contends that this issue is moot because the court of appeals held Smith Barney secondarily liable under *respondeat superior* for its employee George Henricksen's common law violations (breach of fiduciary duty and conversion), as to which secondary liability there is no dispute. Respondent misses two points.

First, the court of appeals did not say whether Smith Barney was liable under *respondeat superior* for George's common law violations, or for his §10(b) violations. If the latter, then the question presented must be resolved. Since that cannot be determined, the question is not academic and a "case or controversy" exists. *Buckley v. Valeo,* 424 U.S. 1, 12, 46 L.Ed.2d 659, 96 S.Ct. 612 (1976); *Aetna Life Ins. Co. v. Haworth,* 300 U.S. 227, 241, 81 L.Ed.2d 617, 57 S.Ct. 461 (1967).

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[1]Edward Brodsky, "Corporate And Securities Litigation: Controlling-Person Liability — A Conflict", 186 *N.Y.L.J.* 10 (July 15, 1981) at p. 1. This issue has received substantial scholarly examination, particularly since this Court's ruling in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 47 L.E.2d 668, 96 S.Ct. 1375 (1976). *See, e.g.,* Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934", 69 *Calif. L. Rev.* 80 (1981); Ruder, "Secondary Liability Under the Securities Acts", *Eighth Annual Institute on Securities Regulation* (P.L.I. 1977).

In any event, if the court of appeals determined that Smith Barney was liable under the state common law doctrine of *respondeat superior* for George's conversion of funds from the couple's joint savings account before November, 1976 ($39,721.11), it clearly erred because Wisconsin law does not impose such liability. A case or controversy exists because the only available source of secondary liability in this case was federal common law. The viability of a federal common law doctrine of *respondeat superior* in federal securities cases is the nub of the controversy presented in the Petition.

A. Neither The District Court Nor The Court Of Appeals Distinguished Theories Of Primary Liability In Determining Smith Barney's Secondary Liability.

In the Seventh Circuit, respondent argued that:

> " . . . a brokerage firm's liability for its employee's violation of Sections 17(a), 10(b) and 15(c)(1) of the Securities and Exchange Act of 1934 rests upon Section 20(a) of the 1934 Act and the *respondeat superior* doctrine." (Plaintiff-Appellant's Brief at 25).

This raises the precise issues set forth in the Petition: whether the requirements of §20(a) are satisfied in this case and whether *respondeat superior* is available as a broader alternative to §20(a). As her secondary-liability issue on appeal, respondent expressly urged *respondeat superior* liability for securities law violations, without any reference to or reliance on common law theories of conversion or breach of fiduciary duty.

In considering whether Smith Barney had secondary liability, neither the district court nor the court of appeals distinguished between secondary liability for common law violations and secondary liability for §10(b) violations. The district court held George accountable for common law conversion and breach of fiduciary duty as well as violation of §10(b). (Pet. App. D-10 to D-12.) Turning to Smith Barney's secondary liability, it distinguished between the option losses and the converted funds, but not between George's §10(b) and common law liabilities. (Pet. App. D-15 to D-22.) Nor did the

court of appeals make or rely on the latter distinction. It discussed "the common law doctrine of *respondeat superior*" only with respect to Smith Barney's "liability for the unlawful acts of its agent, George . . . . " (Pet. App. A-13.) Respondent does not and cannot contest the existence of a case or controversy if, as she urged in the court below, Smith Barney's liability was based on the §10(b) violations. The manner in which the issue of secondary liability was argued to and decided by the courts below thus ensures the continuation of a case and controversy on the issues presented in the Petition.

B. The Wisconsin Law Of *Respondeat Superior* Furnished No Basis For Imposition Of Secondary Liability On Smith Barney.

Although the court of appeals referred to "state common law" in imposing strict *respondeat superior* liability on Smith Barney (Pet. App. A-15), the decision does not refer to a single Wisconsin case dealing with conversion, breach of fiduciary duty, or *respondeat superior.* Instead, the court derived its *respondeat superior* standard from *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1052-53 (7th Cir. 1974) (Pet. App. A-13), a federal case which in turn cites only federal *respondeat superior* cases. It was in reliance on these federal cases — which apparently apply federal common law — that the court held Smith Barney strictly liable for George's pre-November, 1976 violations.[2] The point of Smith Barney's Petition is that such federal common law cannot co-exist with §20(a), a federal statute to the contrary.

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[2]The Seventh Circuit in *Fey v. Walston & Co., Inc., supra,* 493 F.2d 1052, n. 19 adopted, without reference to any state's law, the Eighth Circuit's statement of a "common law principle" that "a principal is liable for the deceit of its agent committed in the very business he was appointed to carry out." *Myzel v. Fields,* 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968). The circuits which have applied this to impose secondary liability in federal securities cases appear to rely on federal law. *See* Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934", 69

(footnote continued)

It is not surprising that the court of appeals did not explain its cryptic reference to "state common law" in holding Smith Barney secondarily liable. The district court's findings of fact are clearly inconsistent with liability under Wisconsin law. Wisconsin's doctrine of *respondeat superior* holds a principal liable for his agent's acts within the scope of his apparent authority, including acts which are fraudulent or against the principal's interest. *Hollingsworth v. American Finance Corporation,* 86 Wis.2d 172, 181, 271 N.W.2d 872, 877 (1978). This requires particularized inquiry into whether the principal's conduct reasonably induced the third party to believe that the agent had authority to act for the principal. *Id.* at 183. To establish apparent authority for the purpose of applying *respondeat superior* in Wisconsin, three elements must be established: (1) acts by the agent or principal which would justify a belief in the agent's authority; (2) the principal's knowledge of such acts; and (3) reliance on the acts by the third party, consistent with ordinary care and prudence. *Silberman v. Roethe,* 64 Wis.2d 131, 151-152, 218 N.W.2d 723, 733 (1974); *Rivera v. Eisenberg,* 95 Wis.2d 384, 393-394, 290 N.W.2d 539, 544 (1980).

The district court's findings of fact preclude Smith Barney's liability under Wisconsin law. The pre-November, 1976 losses occurred when George withdrew funds from his and Wendee's joint savings account. George withdrew the money from the joint account in his capacity as a co-depositor and pursuant to his authority under the deposit contract with the bank. The district court made no finding that Smith Barney purported to tell, or should have told, Wendee how to manage her personal banking affairs. In fact, the district court found that she "could easily have prevented or at least quickly

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Calif. L. Rev. 80 (1981) at 87, n. 41. It remains Smith Barney's position that even this federal formulation was inapplicable here,because George's withdrawal of funds from his and Wendee's joint bank savings account was not a "deceit [the] agent committed in the very business he [George] was appointed [by Smith Barney] to carry out." *See* Petition at pp. 7-8.

detected her husband's fraud by taking reasonable precautionary steps which the facts known to her required." (Pet. App. D-17.) These findings of fact precluded the court of appeals from holding — even implicitly — that Wendee relied on some act of Smith Barney or its agent in a manner "consistent with ordinary care and prudence." *See Motor Castings Co. v. Milwaukee County Bank,* 254 Wis. 493, 36 N.W.2d 687 (1949). Since the found facts compel the conclusion that George's acts were without the scope of his apparent authority, Wisconsin law prohibits the imposition of *respondeat superior* liability.

Respondent's argument that the court of appeals' decision is explainable by reference to state law is unsupportable, because it presumes that that court erred in applying the state common law upon which the argument relies. The only viable interpretation of the court of appeals' decision is that, under federal statutory and common law, strict secondary liability was imposed on Smith Barney for the acts of its registered representative. Whether this ruling is correct is the central issue presented for review in the Petition.

II. ALL ISSUES WERE TIMELY RAISED AS SOON AS THEY BECAME ISSUES IN THESE PROCEEDINGS.

Respondent contends that the three questions presented in Smith Barney's Petition were not raised in a timely manner and should not be considered by this Court (Respondent's Brief, p. 6). Respondent asserts that the first question (relating to *respondeat superior*) was not raised until Smith Barney petitioned the court of appeals for rehearing, and that the second and third questions (relating to *scienter*) were first raised in Smith Barney's Petition.

Smith Barney's first question, regarding the applicability of *respondeat superior,* was not raised prior to the petition for rehearing because Smith Barney had no reason to do so until the court of appeals based its decision on that doctrine.[3]

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[3]Plaintiff-respondent pleaded *respondeat superior,* and succinctly argued that theory in her post-trial brief (at pp. 43-44). Smith

(footnote continued)

Although not phrased in terms of the *scienter* requirement of *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 47 L.E.2d 668, 96 S.Ct. 1375 (1976), Smith Barney's second and third questions were the focus of the entire trial and appeal process. Because Smith Barney raised the "good faith" defense afforded by §20(a) of the Act, much of the evidence received during the trial related to whether Smith Barney had any intent to deceive or was reckless or negligent in its supervision of Wendee's account. The parties fully litigated the issue of *scienter* without calling it that. The district court addressed Smith Barney's culpability at length in its opinion (Pet. App. D-16, D-17, and D-19 to D-22), as did the court of appeals. (Pet. App. A-9 to A-13).

In certiorari proceedings, questions are timely raised if they are presented for the first time in the petition for writ of certiorari. In *Friedman v. Rogers,* 440 U.S. 1, 59 L.Ed.2d 100, 99 S.Ct. 887 (1979), the Court refused to consider a claim that "was neither alleged in the District Court nor mentioned in the jurisdictional statement in this Court", 440 U.S. at p. 19, n. 20. This statement implies that the claim would have been

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Barney in its post-trial brief noted the split between circuits on the issue (at p. 30), not arguing the point because the trial court was unquestionably bound by *Fey v. Walston & Co., Inc.,* 493 F.2d 1036 (7th Cir. 1974). On appeal from the trial court's decision, denying liability under §20(a) as well as *respondeat superior,* appellant Wendee devoted thirty-six pages of her thirty-eight page brief to the proposition that Smith Barney inadequately supervised the account. She cited *respondeat superior* as an alternative basis for secondary liability (pages 24-26) without elaboration. At that stage, the focus was on the facts — not on legal theories. Smith Barney in its brief (as appellee) defended the district court's decision in response to Wendee's arguments that her account was inadequately supervised. Smith Barney did not address the issue of *respondeat superior* at that point because the focus was on the facts and because the Seventh Circuit, in *Fey v. Walston & Co., Inc.,* 493 F.2d 1036, 1052-53 (7th Cir. 1974), had already resolved the *respondeat superior* question against Smith Barney.

timely if it had been raised in either the district court *or* the jurisdictional statement. The same reasoning is implicit in *Dorszynski v. United States,* 418 U.S. 424, 431, n. 7, 41 L.Ed.2d 855, 94 S.Ct. 3042 (1974) and *Espinoza v. Farah Manufacturing Co.,* 414 U.S. 86, 96, n. 9, 38 L.Ed. 2d 287, 94 S.Ct. 334 (1973). It follows that the issues here, properly presented in the Petition, have been timely raised for review by this Court.[4]

III. THE CONFLICT OF AUTHORITY BETWEEN CIRCUITS IS CLEAR AND CONTINUING.

Respondent finally argues that there is no real conflict between the circuits concerning the relationship between the federal securities laws and the common law doctrine of *respondeat superior* (Respondent's Brief, p. 9). That the conflict continues to exist and concerns the securities bar is emphasized by Edward Brodsky's recent column, "Corporate And Securities Litigation: Controlling-Person Liability — A Conflict", on the front page of the July 15, 1981 *New York Law Journal* (Vol. 186, No. 10). Mr. Brodsky writes:

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[4]Respondent cites four cases in support of her contention that Smith Barney did not raise its issues in a timely fashion. None of these cases is on point. In *Lawn v. United States,* 355 U.S. 339, 362 n. 16, 2 L.E.2d 321, 78 S.Ct. 311 (1958), the Court refused to consider an issue which was not even raised in the petition for a writ of certiorari. That is not the situation here. In *Duignan v. United States,* 274 U.S. 195, 200,71 L.E. 996, 47 S.Ct. 566 (1927), the Court refused to consider a challenge to the constitutionality of a federal statute which was first raised in the petition for writ of certiorari. No such challenge is presented by Smith Barney. The third case cited is *United States v. Santana,* 427 U.S. 38, 41, n. 2, 49 L.E.2d 300, 96 S.Ct. 2406 (1976), where (applying the rule that challenges to standing are waived if not presented at trial) the Court declined to consider an issue of standing which was not presented at trial. This case has nothing to do with the stage at which a non-standing issue must be raised. In *United States v. Ortiz,* 422 U.S. 891, 898,45 L.E.2d 623, 95 S.Ct. 2585 (1975), the government asserted a position on an issue which was contrary to its position on that issue before the court of appeals. Respondent has not even suggested that Smith Barney has changed its position in this sense.

> "Courts continue to disagree on the issue of liability of employers for the fraud of their employees under the controlling person provisions of the federal securities laws . . . . The problem is complicated because of conflicts on two separate questions. First, there is the issue of whether an employer is liable for acts of its employees both under the controlling person provisions of securities laws and under the common law principle of *respondeat superior*. The Second, Fourth, Fifth, Sixth, and Seventh Circuits hold that the employer is liable under both theories while the Third and Ninth Circuits reach the opposite conclusion . . . . " (footnotes omitted).

The conflict is substantial. The Ninth Circuit steadfastly rejects the imposition of *respondeat superior* liability for securities violations.[5] The Eighth Circuit has declared that secondary liability in securities cases is not controlled by agency principles. *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967). The Third Circuit takes the same position as a general rule, with increasing exceptions.[6] At least one panel of the

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[5]*Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814 (9th Cir. 1980) does not (as respondent suggests) authorize the imposition of *respondeat superior* liability for a securities violation. (Respondent's Brief, pp. 4, 5). The conflict between common law and the securities statutes is never addressed in *Mihara*; §20(a) of the Securities Exchange Act is not mentioned in the opinion. The language respondent quotes indicates only that a brokerage firm may have *respondeat superior* liability for a common law wrong. Respondent also relies on a Fifth Circuit statement to the effect that the Ninth Circuit has never taken a definitive stand on the issue presented. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1117, n. 5 (5th Cir. 1980). Yet the Ninth Circuit has never retreated from its express holding that §20(a) "supplants" the common law of *respondeat superior* in securities cases. *Christoffel v. E. F. Hutton & Co., Inc.*, 588 F.2d 665, 667 (9th Cir. 1978).

[6]The law in the Third Circuit is confused. Respondent cites *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3rd Cir. 1981), which

(footnote continued)

Fourth Circuit agrees with the Eighth and Ninth Circuits. Other circuits which have addressed the issue impose strict liability on a "controlling person" under the common law doctrine of *respondeat superior*, despite the Congressional declaration in §20(a) of the Act that a "good faith" defense may be raised to the imposition of secondary liability. Regardless of how many panels in how many circuits line up on the respective sides of this issue, the fact remains that there is disagreement among the circuits and even within at least one circuit. This underscores the importance of a resolution by this Court of the questions presented in Smith Barney's Petition.

Respectfully submitted,

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dealt with the secondary liability of an accounting firm whose employees had improperly prepared documents in a securities transaction. Although the case did not involve stockbrokers or a brokerage firm, the Third Circuit in *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 886 (3rd Cir. 1975) suggested, in dictum, that it might favor a broader approach to liability in a stockbroker fraud case, implying that *respondeat superior* as well as §20(a) might render a brokerage firm liable for its employee's fraud. Yet both panels affirmed the general principal that only the secondary liability provisions of the securities laws may be used to hold a controlling person liable in securities cases. *Sharp v. Coopers & Lybrand*, *supra* at pp. 180-181. The Third Circuit's advisory dicta evidence the confusion surrounding §20(a) and the need for this Court to dispel it.